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MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

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Subject: U.S. Monetary Policy and Its Effect on the Domestic and International Economies

Since June of this year, there has been virtually no growth in the money supply or in total reserves of depository institutions. Between June and October, M1 fell by an annualized rate of 0.4% while total reserves fell by 4.2%. As a result, in only four months the money supply has moved from the top of the Federal Reserve's 4-8% target range to just above the bottom. At previous Cabinet Council presentations, we repeatedly have expressed our concern that a continuation of this absence of money and reserve growth could seriously endanger the current economic expansion. Those concerns have intensified, especially in view of the revised 1.9% growth in real GNP for the third quarter of this year.

Normally, one quarter of weak economic performance is not atypical during an economic expansion. But the evidence for October, such as the decline in retail sales (-0.1%) and in durable goods orders (-4.1%), adds to our concern, particularly within the context of the declines in money and reserves.

Effects on Other Countries

If real economic growth in the U.S. were to continue at a low pace or even to turn negative for more than a quarter or two, there would be significant unfavorable consequences for the U.S. economy as well as for other countries. Certainly the economies of other industrial countries would be affected, but probably the most seriously affected group would be the Latin debtors.

The most obvious effect on other countries of a change in U.S. GNP growth is a change in U.S. imports. The OECD Secretariat has estimated that a one percent decrease in U.S. real economic growth would reduce foreign industrial country real GNP by more than 0.1 percent. For some countries -- e.g., Canada and Japan -- the effect is considerably greater. These effects operate directly -- via reduced U.S. imports -- and indirectly -- via reduced demand for third-country exports by countries trading directly with the United States.

The U.S. expansion had an additional effect which is impossible to quantify: the confidence-restoring aspect of our strong growth has been vital in encouraging demand and growth abroad, particularly in Europe. Rapid U.S. growth in the current expansion emerged at a time when extreme pessimism about recovery was growing, and helped to dissipate the gloom. The U.S. economy was largely the engine which helped pull the European countries out of their recessions. As a result of the success of the U.S. supply-side experiment, the industrialized countries are now beginning to talk about adopting aspects of Reaganomics: cutting taxes; increasing incentives to save, invest and work; deregulating; reducing the rate of growth of government spending; etc. (This has also been true with the Latins.) If we continue to provide a model for the world to emulate, and supply-side measures are implemented by our allies, it will mean a resurgence of economic growth world-wide. However, if Reaganomics is perceived as having failed, and other countries abandon their supply-side efforts, world economic growth will suffer.

While the effects of a slowdown of the U.S. economy on foreign OECD countries would be modest, though real, it could lead to an increase in European unemployment. Structural problems -- such as very inflexible labor markets, disincentives to hiring labor such as high real wages and excessive job security, and overgenerous provisions for unemployment -- have prevented strong European recoveries, leaving unemployment high and, in most countries, rising. The Europeans will have to tackle these problems themselves, but the incremental effect of slower U.S. growth will add to their policymakers' problems.

LDCs also had been benefiting from the U.S. economic expansion. U.S. imports from non-OPEC LDCs in the first three quarters of this year were $20 billion above the level of the same period of 1982. In Latin America alone, between 1982 and 1984, the IMF projects a $27 billion improvement in the aggregate current account balance, $23 billion of which is attributable to the United States: higher U.S. imports, lower U.S. exports, and an improved Latin current services balance (including lower net interest payments to the U.S., as interest rates have fallen since early 1982).

While a U.S. slowdown would presumably lower interest rates further (a net reduction of $2.5-$3 billion in interest payments for all LDCs results from every one percent fall in U.S. interest rates), the reduction in U.S. imports would far outweigh this gain to the LDCs. With many of these countries in difficult financial situations, the net weakening of their external finances could be serious. A reduction in their exports to the U.S. will make it difficult for many of the Latin countries to meet the economic targets specified in their IMF programs. If these countries then fall out of compliance with their Fund programs, their ability to reschedule their foreign bank debt will be seriously hindered. This could also result in adverse consequences for U.S. banks with large exposures in the major debtor countries. In addition, Mexico and Venezuela could feel the effects of lower U.S. growth on their oil prices and earnings, compounding their financial difficulties. --

Current Market Conditions and Federal Reserve Policy

The declines among interest rates which began for long-term rates in late June and short-term rates in late August have continued through November. There is room for further improvements in interest rates as a result of the continued decline in inflationary expectations and additional improvement in the perceived stability of the U.S. banking sector. According to the Blue Chip consensus, between June and October, expected inflation for 1985, as measured by the GNP deflator, fell 100 basis points from 5.7% to 4.7%. Between October and November, expected inflation fell another 30 basis points. The spread between the rate on banks' certificates of deposits and the Treasury bill rate fell from 80 basis points in early October to about 50 basis points at present. In late June, this index of banking risk was approximately 180 basis points.

The Federal Reserve's decision to cut the discount rate from 9% to 8.5% on November 21 was appropriate and welcome, although it did occur somewhat later than had been expected by the financial markets. The discount rate can act as a floor for the average Federal funds rate, which in turn, as a result of Fed operating procedures, exerts considerable influence on other interest rates. It is our desire that additional cuts in the discount rate occur more speedily in response to market conditions. Past delays -- such as in 1982 -- in adjusting the Federal funds and discount rates promptly have tended to delay both downward movements in market interest rates and renewed monetary growth, while suppressing the rate of real economic growth.

While money growth has yet to move up, we are moderately encouraged by early signs of a pickup in reserve growth in the last two weeks and by the recent discount rate cut. But a more sustained growth in reserves and a still lower Federal funds rate may be needed before adequate money growth can be expected. Given the lags between money and real growth, the major real economic effects of a new Federal Reserve policy may not materialize for another one or two quarters. That is why, if we are to avert the serious domestic and international consequences of the June - October monetary tightness, the Fed must act now to extend its apparent easing of monetary policy.